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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	

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NYNEX COMMENTS ON USTA PROPOSAL

The NYNEX Telephone Companies[1] hereby file their Comments on the modified price cap proposal submitted by the United States Telephone Association ("USTA") on January 18, 1995.

USTA proposes that price cap carriers be permitted to elect a new price cap option that would include: (1) a productivity factor based on a moving five-year average of the local exchange carrier ("LEC") Total Factor Productivity differential ("TFP") with a two-year "lag"; (2) no sharing or lower formula adjustment; (3) an initial consumer productivity dividend ("CPD") of 1%, phased down over three years, in place of the current 0.5% CPD; and (4) an initial one-time reduction of 1% in the price cap indices. A LEC would be

[1] The NYNEX Telephone Companies are New York Telephone Company and New England Telephone and Telegraph Company.

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allowed to elect this option or to remain with the current price cap formula. USTA also proposes that the Commission adopt a narrowed definition of exogenous costs that would include only government-mandated changes that uniquely affect telecommunications companies and changes in universal service funding. Finally, USTA proposes that the Commission adopt a three-part rulemaking procedure for implementing a more flexible regulatory structure to take into account increasing levels of competition in interstate access markets.

NYNEX supports the USTA proposals. NYNEX agrees that sharing should be eliminated if a LEC chooses the USTA option, because the moving five-year average TFP factor would ensure that customers would share in any productivity gains realized by the LECs. The Commission adopted the sharing and lower formula adjustment factor as "backstops" in case its calculation of industry productivity was not accurate.[2] The moving average would be an automatic backstop that would obviate the need for frequent reexaminations of industry productivity.[3] Elimination of sharing would have the additional benefit of encouraging the LECs to become more efficient, while giving consumers the benefit of increased efficiencies after a two-year lag through the moving productivity factor. Finally, if the Commission adopts USTA's earlier proposals to permit services to be moved out of price caps as they become

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[2] *See Policy and Rules Concerning Rates for Dominant Carriers,* 5 FCC Rcd 6786, para. 120 (1990).

[3] NYNEX supports the Christensen model for determining the LEC TFP. This is the only approach on the record that accurately reflects the moving average for LEC productivity.

subject to competition, the elimination of sharing would allow the LECs to avoid making difficult cost allocation showings as services are removed from price caps. Without sharing, the LECs would not have to identify the costs associated with services that remained subject to price regulation in order to calculate the rates of return in those services.

An important feature of USTA's proposal is that it would be optional. A LEC may need to remain with the current price cap rules if unusually strong competition or other factors are causing it to experience lower productivity growth than the rest of the industry. A LEC with low earnings could be financially harmed if a higher industry productivity standard were made mandatory.

NYNEX also supports USTA's proposal to streamline the definition of exogenous costs. This would provide a more predictable environment for the industry, and it would reduce the cost to all parties of administering the price cap system.

USTA has also proposed a reasonable set of procedures that will address the need for a more flexible price cap system. NYNEX agrees with USTA that the Commission should take steps in its initial order to increase the pricing flexibility of the LECs. In particular, the Commission should (1) reduce the lower band limits to 15% within all service categories and sub-categories; (2) eliminate the DS1 and DS3 sub-indices; (3) extend zone pricing to the local switching category and to all elements in the transport category except the interconnection charge; and (4) streamline the regulations for tariffing new services.

While the USTA proposal has considerable merit, it does not go far enough. The USTA proposal does not provide a meaningful alternative to the current price cap system for a LEC facing substantial competition.[4] Such a LEC is likely to have lower-than-average earnings and lower productivity, which would make it difficult for the LEC to elect out of sharing under the USTA proposal.[5] The sharing mechanism is unnecessary for a LEC operating in a competitive market, because the lower prices that are produced by competition already allow the consumer to "share" in LEC productivity. Therefore, the Commission should adopt a third option under which a LEC could petition for elimination of sharing by demonstrating the existence of meaningful competition in its service area.

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[4] As NYNEX has stated in recent *ex parte* contacts, competition will develop at different rates in different geographic areas of the country in response to local concentrations of traffic and in response to the variations in state regulatory frameworks for local exchange competition. Just last week, NYNEX and MFS announced a co-carrier interconnection agreement that MFS described as "a milestone toward the development of effective local telephone competition." *See MFS News Release* issued January 25, 1995. The interconnection agreement includes provisions for mutual compensation, interim number portability, seamless network interconnection, and integration of MFS numbers in NYNEX directory assistance databases.

[5] The USTA proposal provides that if a LEC elected the no-sharing option after the initial year, it would be subject to the 1% up front reduction and to the CPD factor then being used by the rest of the industry. *See* USTA Proposal at pp. 5-6.

Attached is a paper that NYNEX provided to the Commission as part of an *ex parte* presentation. In this paper, NYNEX proposes that, in addition to the option advanced by USTA, the Commission allow for the elimination of sharing through a showing that certain competitive criteria have been met.[6] After making such a showing, a LEC could transition to a price cap plan that did not include sharing, but that allowed the LEC to choose either the fixed TFP or a transition to the moving five-year average TFP, whichever is lower, without the CPD. This formula is reasonable, because a LEC facing a competitive local exchange market will have a lower TFP than the industry average, unless the industry as a whole is facing similar competition. In addition, the CPD is unnecessary because competition will be more effective than the CPD in ensuring that consumers will enjoy lower prices.

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[6] This option would apply only to the issues of sharing and the application of the productivity factor. USTA's proposal for pricing flexibility based on the classification of rates into initial market areas ("IMAs"), transitional market areas ("TMAs"), and competitive market areas ("CMAs"), would apply whether a LEC chose the USTA option or the NYNEX option.

For these reasons, NYNEX supports USTA's proposals and it urges the Commission to adopt the additional option proposed by NYNEX for LECs facing increased competition.

Respectfully submitted,

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Sharing and Access Reform: Conflicting Goals

It is generally recognized that the existence of a sharing mechanism in a price cap regime represents a less than optimal situation. The incentives of a firm toward greater efficiency that form the basis of any price cap plan are muted by any requirement to "give back" some of the gains made by the firm, and it is only when the loss of that greater efficiency is more than offset by the need for consumer safeguards that sharing can be justified. Under this situation, one must view sharing, then, as a necessary evil, a consumer safety net in case a productivity factor is set too low and earnings will otherwise rise to immoderate levels because market forces are not present in sufficient amounts to maintain prices at economic costs. In the current review of price caps, the record supports the elimination of sharing. If the Commission decides to retain sharing, however, or eliminate it only through an option involving a higher productivity hurdle, it must also allow for the elimination of sharing through a competitive showing. This paper will examine in brief the implications of a sharing requirement on attempts to reform Access pricing, and under what circumstances this "necessary evil" can and should be eliminated.

Sharing and Competition

The case for a sharing mechanism essentially rests on the absence of vigorous competition in a market. The salutary economic benefits of competition are well known and can be listed, but they amount to no more than an assurance that consumers reap some benefit from the market forces put on firms. Other means exist to create these assurances, and the Commission can employ these less efficient alternatives to market forces if it desires to eliminate the sharing mechanism. The Consumer Productivity Dividend (CPD) is one such mechanism. It exists solely to raise the hurdle over which LECs must pass to realize the advantages of price caps. It is possible, therefore, that some firms could and would accept a yet higher CPD hurdle to gain the greater efficiencies that come with a pure price cap regime. This option, however, is only feasible for firms not yet embroiled in a highly competitive market. This is so because, as competition takes hold in a market, and until market share stabilizes, competition dampens productivity and earnings to a degree that will not allow a firm to overcome any greater hurdle. In such a situation, productivity will decline during a transition period as outputs, i.e., demand and revenues, are eroded more rapidly by competition than most inputs can be reduced, viz., fixed expenses and common overheads cannot in the short term decline as rapidly. In the long term, as corporate downsizing takes effect, market share stabilizes, and a smaller, leaner firm emerges, productivity can increase again; but at that point, however, competition has been firmly established as the regulator of the marketplace. Long before that point is reached, of course, a sharing requirement is unnecessary. The historical results of earnings and demand for NYNEX since the inception of Price Caps suggest that it is in this transition phase, and that the Commission must now consider a means by which carriers like NYNEX, which cannot "afford" to provide the expedient assurances of an inflated CPD, can make a sufficient showing that sharing is no longer necessary based on the existence of competition.

Sharing and Access Reform

Establishing criteria that will allow for the elimination of this "necessary evil" is important to the Commission for two reasons. First, sharing must be eliminated before Access Reform can be implemented, because a necessary part of such reform is the need to remove portions of broad markets from under price cap regulation as competition for services grows and becomes firmly rooted in geographic pockets throughout a serving area. We'll examine this impetus in a moment. The second reason sharing must be eliminated as markets become more competitive has to do with the need to eliminate the lower formula adjustment ((LFA). The LFA cannot be equitably eliminated unless the requirement to share is also done away with, since the two were crafted to provide a balanced approach to protecting consumers from excessive LEC earnings if the X factor was set too low, and, at the other end, protecting LEC stockholders from confiscatory earnings levels if the X factor were set too high.

To elaborate further on this second reason before returning to the first, it should be noted that competition in the transition period will erode earnings, and that earnings can therefore decline to a level that would trigger a LFA, if provisions for one exist. Implementing a LFA would mean that, in areas and services with relatively inelastic demand, competitive losses could be partially recouped by a LEC. Pressure for sustained short term earnings, combined with the essentially inelastic demand of some services in some areas, e.g., residential and small business customers in rural areas, would encourage this unintended abuse of the LFA. The LFA must be eliminated as markets become competitive, and the Commission can only do so by also eliminating sharing.

Returning now to the first reason that sharing should be eliminated, the Commission must envision the patchwork of competitive areas and services that is rapidly forming, and which requires a targeted approach to regulatory relief. The NYNEX Universal Service Preservation Plan (USPP) provides an example of the type of disaggregation that could be useful in differentiating among services and zones within a region, although it is not the only valid approach. The USPP distinguishes between multi-line and single-line customer services, and it establishes three different zones based on the amount of competition that is present in each, with Zone 1 representing the most competitive zone. One would expect that the most competition would be for multi-line customers in Zone 1 (as in fact is the case), and that it would be those services in Zone 1 that would first be granted streamlined regulation because of competition.

With a requirement for sharing still in place, however, and with the Part 69 requirement to allocate costs on a study-area level, no services in *any* zone, no matter how competitive, could be removed from under price caps, because of the need to extract out the associated costs and revenues, and the impossibility of doing so on such a sub-study-area, sub-switch basis. Since telephone switching equipment provides multiple services in each central office (CO), and since only *some* services would be competitive in that CO, an allocation mechanism would have to be developed on a switch-by-switch basis -- essentially an accounting morass. The upcoming tariff filings for Video Dialtone may raise this problem even before any Access Reform efforts are completed.

One possible solution to the cost allocation problem with the sharing requirement in place would be to allow cost allocation below a study-area level, and to remove *all* services in a zone from price cap regulation, once competition in that zone has reached a predetermined level. That would solve the problem of needing to apportion switch costs, but, even apart from the Part 69 changes it would require, it would create a situation in which all services in an area or zone are removed from price cap regulation even though only some customers in that area (e.g., multi-line customers) have competitive alternatives. Another solution might be to treat services removed from under price caps as is done today, viz., assume that revenues equal costs for these services. Such an approach works well enough when the services and associated revenues outside of price caps are quite small. Once major portions of revenues are removed from under price caps, however, the charge could be made that the return from these competitive services is drawing down the overall return and thereby lessening a sharing obligation and allowing less competitive services to absorb and offset the downward pressure on competitive service rates.

The politically more palatable approach of targeting regulatory relief more precisely is possible only with a two-dimensional approach like the one employed in the NYNEX USPP, and that approach requires that there be no requirement for sharing. Fortunately, since both the need for regulatory relief and a case for the elimination of sharing can be based on the presence of competition, an elegant solution is possible in the form of establishing criteria that will allow the Commission to eliminate sharing on a LEC-specific basis, once competitive inroads are sufficient.

Criteria To Be Used

The criteria to be used in assessing whether sharing can be eliminated will no doubt be the subject of much debate, hence, the Commission must begin immediately to consider them. NYNEX suggests that they include both quantitative and qualitative elements, since the latter alone may not provide adequate assurances, and the former are necessarily historical and inequitably dilatory in a time of rapid change in the marketplace. Quantitative data should be based largely on earnings trends, supplemented by demand data, rather than solely on market share, which is difficult for LECs to obtain and in any case is less meaningful when seeking to assess competitive inroads across an entire region. Quantitative data should largely be used to see if competition has formed, whereas qualitative data should be used to confirm that the competition that *has* formed will flourish. In that regard, information on the deployment of competing networks, LEC efforts to promote competition, and the regulatory environment in a region should be key. The showing ought to be that a "substantial portion" of LEC revenues across a region are subject to competitive threats, and that the LEC and regulators in the region have taken actions that allow for robust competition. The qualitative criteria include:

- Are competitors (CLECs) allowed interconnection to points within the LEC network where technically and economically feasible?
- Do CLECs have access, on an unbundled basis, to LEC network functions, services, and information, including databases, signaling, and network routing processes?
- Do CLECs have equal access to poles, conduits, and rights of way?
- Does the LEC integrate competitors' Class 4 and 5 switches into the LEC traffic routing plan through unbundled switching and facility elements at cost-based rates?
- Are CLECs allowed to resell and share unbundled LEC network services?
- Have state and federal franchise restrictions to entry been eliminated, so that any competitor can enter the local exchange market?
- Do CLECs have non-discriminatory access to telephone numbers?
- Do LECs and their competitors compensate each other for terminating traffic on each others' network?
- Have LECs and CLECs established cooperative engineering, operational, maintenance, and administrative practices and procedures?
- Has the LEC taken reasonable efforts to make telephone numbers portable?

Armed with the assurances derived from these quantitative and qualitative data, the Commission would then act to eliminate the sharing requirement for the petitioning LEC. It would still require further, particularized information, if the LEC contended also that some classes of services in certain areas or zones faced demonstrably sufficient competition to warrant having them removed from price cap regulation. The showing for regulatory relief would still rely on a mix of quantitative and qualitative data, but, because of the localized nature of the competition, a heavier reliance could be placed on quantitative data, including market share.

Conclusions

The Commission can and should eliminate the sharing requirement. To address the concerns expressed by some parties in this proceeding, two methods can be developed to allow it to achieve this desirable end: 1) it can impose an additional CPD to insure that LECs with the ability to do so can flow the effects of a greater productivity offset to consumers; 2) it can establish criteria that will provide it assurances that consumers will benefit because competition has developed in a region. In the rapidly evolving environment in which a nationwide, homogenous market no longer exists, and which requires the singling out of individual areas and services ripe for access reform, the Commission must take steps now to allow consumers to gain the benefits of a pure price cap regime and to allow LECs contribute to the growth of the competitive marketplace and to the robust deployment of the Information Age infrastructure.

CERTIFICATE OF SERVICE

I hereby certify that copies of this pleading were mailed this date, first class postage prepaid, upon the persons listed on the attached service list.

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Dated: January 31, 1995

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